

Massachusetts' Extended Bond Purchase Program

The Clean Water State Revolving Fund Program (CWSRF) provides states the flexibility to use a variety of financial assistance options including loans, insurance and guarantees for local debt, security for leveraging, guarantees for sub-state revolving funds, and refinancing or purchasing local debt. To date, states have found that the low interest loans available through the program are extremely popular. Since program inception the CWSRF has provided over 6,800 loans that total over \$22 billion.

Some CWSRF programs enter into a loan agreement through the purchase of a local bond. This approach is made eligible under section 603(d)(2) of the Clean Water Act (CWA) that allows states to buy or refinance local debt obligations. In practice, states that provide CWSRF assistance by purchasing a local bond consider it to be equivalent to a loan as defined in the CWSRF program. The interest rate on the bond may range from 0 percent to market rate and the term of the bond may be up to twenty years. The bond is viewed as the state's legal instrument used to enter into an agreement that is equivalent to a loan agreement.

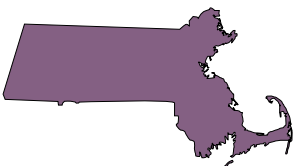
Recently, the Commonwealth of Massachusetts proposed that purchasing a local bond as authorized under section 603(d)(2) of the CWA is fundamentally different from a loan allowed under section 603(d)(1) in that loans are limited to a 20 year repayment term while bonds are not given a limit on

the term of repayment. As a result, the Commonwealth reasoned that they should be allowed to extend the term for repayment of a local bond to the lesser of the useful life of the project or 30 years.

In reviewing the Commonwealth's initial proposal EPA reaffirmed that, in general, CWSRF loans that use a local bond as the legal instrument for the agreement may not extend CWSRF loan repayments beyond 20 years. However, the Agency did accept the subsequent Massachusetts proposal to implement a bond purchase program that extends payments up to 30 years because the Commonwealth has taken extraordinary measures to both ensure that the funding levels of the CWSRF would not be harmed by the bond purchase program and to provide substantial additional assistance to local borrowers.

To receive approval for this approach the Commonwealth committed to 1) provide capital investment into the CWSRF program that is in addition to the 20 percent state matching funds required under the CWSRF program—the Commonwealth will continue to make deposits to provide a 50 percent subsidy for annual loan repayments and 2) modify its leveraging structure to ensure that the purchasing power of the CWSRF would not be diminished over the long-term due to the 30 year term allowed for the bond purchase program. This update describes the Massachusetts extended bond purchase program and the conditions under which the proposal was accepted.

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Overview of Massachusetts' CWSRF Program

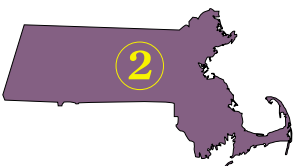
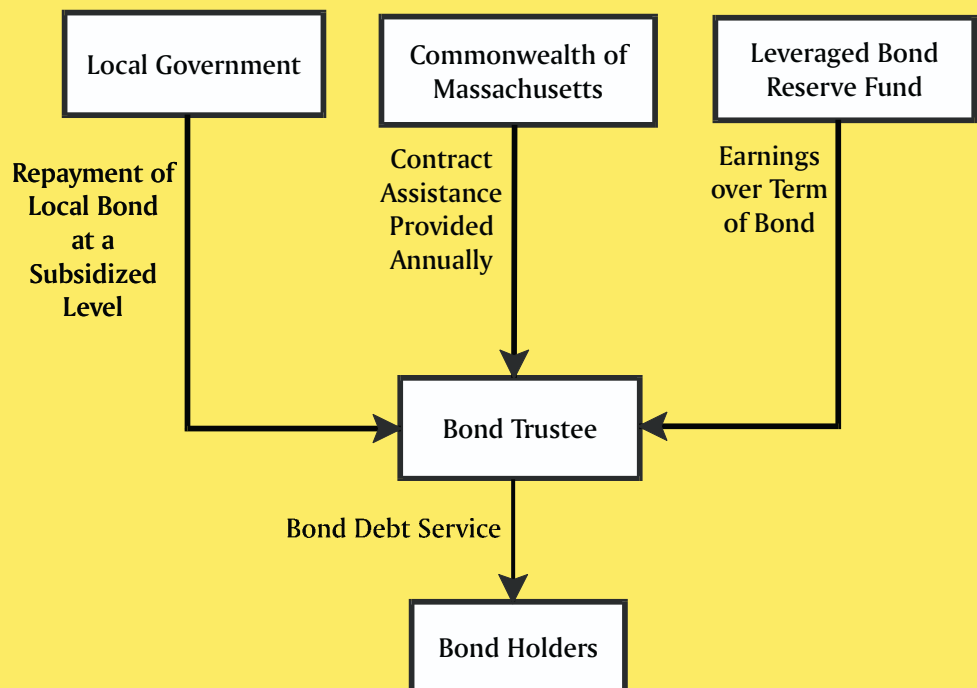
In Massachusetts, the CWSRF program is operated by the Water Pollution Abatement Trust (Trust). Since its inception the Trust has provided more than \$1 billion in assistance to local governments. The Commonwealth's CWSRF program uses reserve fund leveraging but also offers a direct loan program for very small projects and an interim financing program for projects in anticipation of permanent financing. As part of the CWSRF program, the Commonwealth provides annual debt service subsidies to local governments to reduce borrowing costs. The "contract assistance" payments that are provided by the Commonwealth are credited against the debt service payments that are due from local borrowers. Coupled with interest

funded by capitalization grants, the cash flow of these subsidies equate to a minimum of a 50 percent subsidy on debt service payments.

Exhibit 1 displays the leverage bond repayment process in Massachusetts' CWSRF program. The local government repays a portion of principal that reflects the level of subsidies provided. The remainder of the bond debt service is paid with direct contract assistance from the Commonwealth and interest earnings from the debt service reserve fund. The contract assistance payments are appropriated annually, but are a general obligation of the Commonwealth for the life of the financing.

Coupled with interest earnings from debt service reserves funded by capitalization grants, the cash flow of these subsidies equate to a minimum of a 50 percent subsidy on debt service payments.

Exhibit 1
Bond Repayment Cash Flows



Extended Bond Purchase Program

The Commonwealth of Massachusetts initiated its Extended Bond Purchase Program as an additional CWSRF assistance option. This program is available to local government units that are undertaking water pollution abatement projects with useful lives beyond 20 years.

Under this program, project costs for eligible projects will be financed or refinanced with proceeds of bonds (local government obligations) issued by participating local governments and purchased by the Trust. The local government bonds will be either general obligations of the borrowing local government or special obligations secured by specified pledged revenues.

Principal and interest payments on the local government obligation bonds purchased by the Trust must commence within one year after completion of the applicable project. The bonds must be fully amortized within a period that does not extend beyond 30 years from the project completion date or the useful life of the project—*whichever is shorter*. Local obligation bonds must otherwise conform to the same requirements imposed on loans made under section 603(d)(1) of the CWA and the CWSRF regulations. Contract assistance made by the Commonwealth may not be credited toward the state match. When financing a project on an extended basis, the Trust will adjust its financial parameters to compensate for the longer repayment period. Specifically, the Trust will reduce its reserve fund level to 40 percent for an extended bond financing compared to 50 percent under the Trust's Leveraged Loan Program. Projects with amortization schedules between 20 and 30 years may employ proportionally sized reserves to maintain the recycling level.

Decreasing the reserve fund level will offset the reduction in funding due to the longer amortization period of bonds beyond 20 years. In addition, all financing under the Extended Bond Purchase Program will continue to receive the benefit of contract assistance payments from the Commonwealth.

To date the Commonwealth has committed to \$538 million in subsidies for existing loans. In the case of the Leveraged Loan Program, contract assistance payments are credited to borrowers in full, upon receipt, in semiannual payments over the maximum 20 year term of each loan. However, in the case of the Extended Bond Purchase Program, contract assistance payments will also be provided by the Commonwealth over a 20 year period, but will be credited to local bond issuers over a maximum of 30 years, consistent with the terms of the financing employed. Under this program, a portion of these assistance payments are credited to the local issuer upon receipt and a portion is held by the Bond Trustee in a subsidy account within the CWSRF. This retained amount, together with all investment earnings, is credited to local issuers over the term of the local bonds in excess of 20 years.

The Commonwealth is authorized to offer the Extended Bond Purchase Program under the following conditions: 1) there is significant contract assistance provided, 2) the Commonwealth modifies its leveraging structure to offset the loss in recycled CWSRF funding, and 3) the program requires the purchase of a local bond as defined under section 603(d)(2) of the CWA.

The Extended Bond Purchase Program is available to local government units that are undertaking water pollution abatement projects with useful lives beyond twenty years.



Summary of Key Features

Massachusetts' Extended Bond Purchase Program is a unique program that gained approval because the Commonwealth is 1) taking measures to offset the loss to the CWSRF funding levels that would result from extending amortization schedules from 20 to 30 years and 2) providing substantial contract assistance subsidies to reduce the cost to local borrowers. The bond purchase program illustrates the flexibility that states are given to coordinate their CWSRF programs with unique state financing approaches. In approving the Massachusetts program, EPA recognizes that, given the numerous differences found in leveraged and direct loan programs, it would be inappropriate to apply policy without consideration for special conditions that exist in CWSRF programs. When possible the Agency will allow flexibility in financial structure so long as the sought after arrangements are consistent with federal law and regulations and it can be documented that the funding levels will be maintained for the program over time.

Massachusetts' Extended Bond Purchase Program has the following features:

- The extended term provided for the repayment of local bonds will be the useful life of the underlying asset or 30 years, whichever is shorter.
- Local borrowers will establish a dedicated source of revenue for bond repayments.

- All local bond principal and interest will be repaid to the CWSRF.
- Local bond interest rates will be set between 0 percent and the market rate.
- Massachusetts will adjust its leveraging structure by reducing the reserve levels for extended financing so that historic recycling patterns in the CWSRF will not be impeded.
- Contract assistance will be provided to the borrowers that issue 30 year bonds. Borrowers are eligible for assistance that is equivalent to a 50 percent grant.
- The Commonwealth will not offer this program to private entities.

This update was prepared by EPA Headquarters. States interested in further information on the using an Extended Bond Purchase Program should contact their EPA Regional Office SRF Coordinator.

